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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. 1312

JOHN A. WATHEN DISTILLERY COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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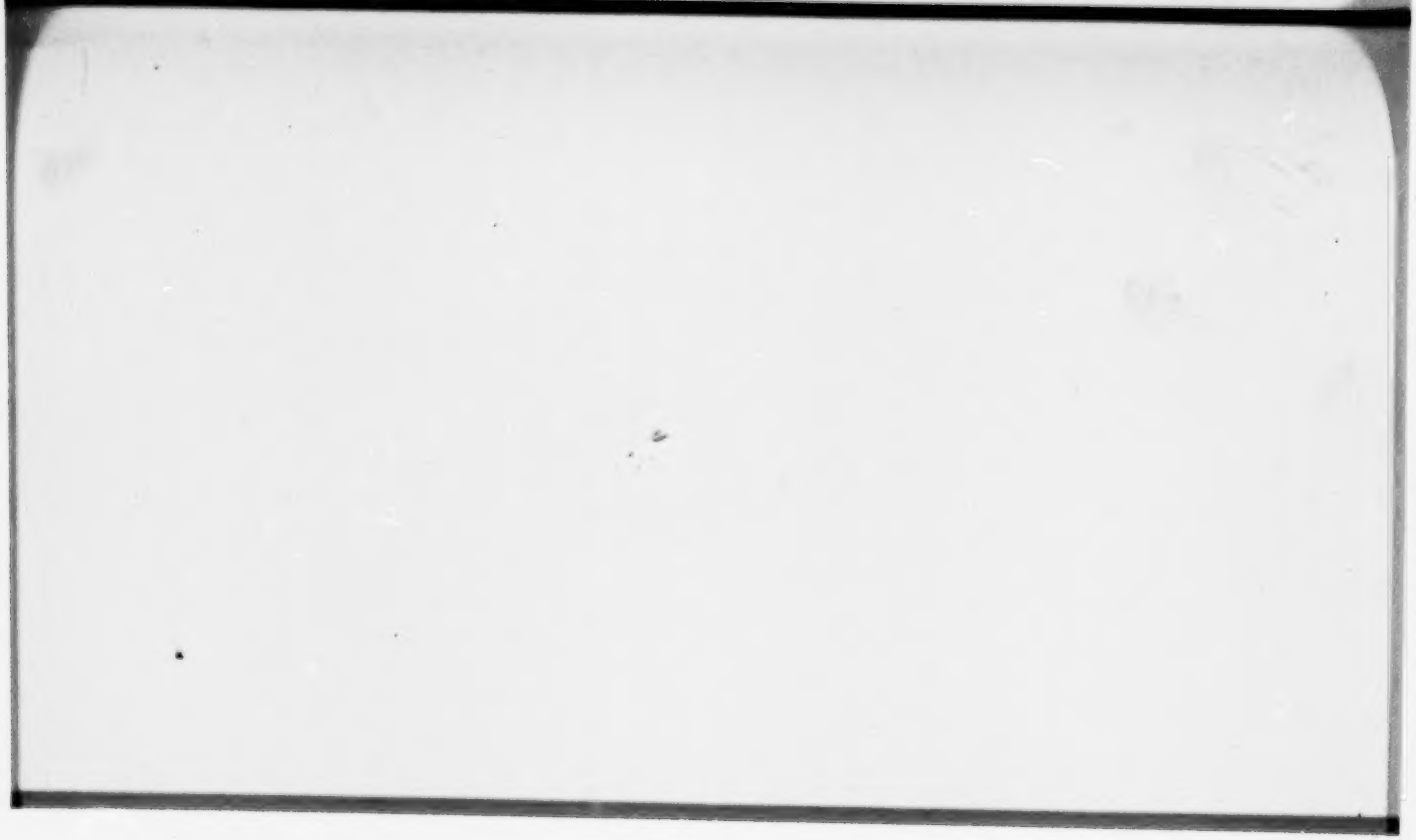

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COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Your petitioner, John A. Wathen Distillery Company, prays that a Writ of Certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled cause on February 14, 1945 (R. 93), petition for rehearing (R. 101-142) denied April 3, 1945 (R. 151), reversing a decision of the Tax Court of the United States (R. 81). The Tax Court held that the Commissioner erred in determining against Wathen income tax deficiencies of $100,751.67 for the year 1936 and $37,182.72 for the year 1937 due to imposition of surtaxes on undistributed profits under the Revenue Act of

1936, § 14, when in fact no deficiencies existed because Wathen was entitled to a dividends paid credit under § 26(c)(1) of that Act to the full extent of its undistributed profits.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 68-81) is reported in 1 T. C. 1188. The opinion of the Circuit Court of Appeals (R. 94-100) has not as yet been reported.

JURISDICTION.

The jurisdiction of this Court is invoked under § 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1936 (49 Stat. at L. 1648), § 26(c)(1) allows a dividends paid credit equivalent to the amount of income which cannot—

> "be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Treasury Regulations 94, Art. 26-2(b) provides that—

> "The credit provided in Section 26(c)(1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly *deals with the payment of dividends* and *operates as a legal restriction* upon the corporation as to the amounts which it can distribute within the taxable year as dividends." (Italics supplied)

QUESTION PRESENTED.

Whether the Circuit Court erred in reversing the decision of the Tax Court that under § 26(c) (1) Wathen was entitled to a dividends paid credit by virtue of a letter it wrote to

Provident Bank stating that it did not intend to pay any of its surplus to stockholders, that it had no intention of declaring any dividends until its borrowings had been materially reduced, and that it would not declare any dividends while indebted to Provident without first consulting* Provident, which letter was written after Provident advised Wathen that it would not lend Wathen money unless Wathen entered into a written contract with it not to pay any dividends without its permission while indebted to it and which letter both Provident and Wathen considered to be the written contract called for in their negotiations.

SUMMARY STATEMENT.

The Tax Court found the following facts:

(1) On April 28, 1935, Provident Bank advised Wathen that it would lend Wathen money "only if it entered into a written contract with Provident not to pay any dividends without Provident's permission while it owed Provident money." (R. 70)

(2) On April 29, 1935, Wathen wrote and delivered to Provident a letter reading as follows:

> "Confirming conversation held with you with reference to the surplus of this company, wish to state that it is not the intention of the officers or directors of this company to pay any part of this surplus out to the stockholders. We furthermore desire to state that we have no intention of declaring any dividend until such time as the borrowings of this company have been materially reduced. We might also state that we will not declare any dividend in the future while indebted to your bank without first consulting you." (R. 70)

(3) Wathen and Provident "considered this letter to be the required written contract whereby petitioner obligated itself not to pay any dividends while indebted to Provident without first securing the consent of Provident." (R. 71)

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*For dictionary meanings of "consult" see pages 11 and 12 of this petition.

(4) Wathen "paid no dividends in 1936 or 1937 because it considered it was bound by a written contract with Provident * * * not to pay any dividends without the banks' consent, and in each year the banks had refused their consent." (R. 73)

(5) Wathen's letter "coupled with Provident's acceptance of its terms, followed by the making of loans to petitioner, constituted a written contract executed by petitioner prior to May 1, 1936, which expressly dealt with dividends and prohibited petitioner from the payment of any dividends in 1936 or 1937 without first securing the consent of Provident." (R. 73)

The Tax Court (five judges dissenting) held that Wathen was entitled to the credit. The Tax Court said:

> "Respondent, in his brief, after citing a number of cases holding that the provisions of section 26 (c) (1) must be strictly complied with by the taxpayer corporation to secure the credit therein provided, says:
>
> > * * * From the strict test enunciated in these cases, it would seem that, for the purpose of said section 26 (c) (1), the contract restricting the payment of dividends should be expressly stated therein, that it should be executed by the proper officer of the claimant, attested by the secretary and sealed with the corporate seal. * * *
>
> We agree with all the foregoing requisites except that which says that the written contract must be 'attested by the secretary and sealed with the corporate seal.' There is no such formal requirement to be found in the statute or in the Treasury regulations." (R. 75)
>
> * * * * * * * * *
>
> "We think that this letter, coupled with the circumstances of its delivery to the bank and acceptance by the bank in making its loan, constituted a written contract entered into by petitioner prior to May 1, 1936, which expressly dealt with the payment of dividends and operated as a legal restriction upon petitioner as to the amounts which it could distribute within the two taxable years before us as dividends. We so hold.

This decides the only issue in the case in favor of petitioner." (R. 79)

On review the Circuit Court conceded that

(1) Provident advised Wathen it would make a loan to Wathen "only on condition that it enter into a written contract with Provident not to pay dividends without Provident's permission while it owed Provident money" (R. 94);

(2) Wathen then wrote Provident the letter above set forth (R. 94-95);

(3) "On the strength of this letter Provident extended respondent [Wathen] a $50,000 line of credit" (R. 95);

(4) The foregoing were "essential facts found by the Tax Court and concerning which there is no dispute" (R. 95);

(5) "The promise to consult * * * might reasonably be interpreted, as between respondent and Provident, a promise to declare no dividends without Provident's consent" (R. 97-98); and

(6) "Officers of respondent [Wathen], in addition to officers of Provident, as well as other creditor banks, testified that they regarded such to be the meaning of the agreement to consult." (R. 98)

But the Circuit Court (McAllister, J., dissenting) held that although the letter actually operated between the parties as a legal restriction upon the payment of dividends, nevertheless Wathen was not entitled to a credit under § 26(c)(1), and that the Tax Court erred in resorting to the surrounding circumstances and the intention of the parties in determining the meaning of the contract.

A petition for rehearing was duly filed (R. 107-142) but denied, McAllister, J. again dissenting (R. 151).

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred

(1) In disregarding this Court's decision in *Dobson* v. *Commissioner*, 320 U. S. 489, which was urged upon the appellate court below.

(2) In reversing the Tax Court's finding of fact that the words "consulting you" were used in the agreement in the sense of "securing the consent of Provident Bank".

(3) In holding that the Tax Court was obliged to look exclusively to the bare terms of the writing and should not have considered testimony concerning the intent of the contracting parties and the circumstances surrounding the execution of the agreement in determining in which of its several equally well recognized meanings the word "consulting" was used in the agreement.

(4) In deciding that the Tax Court erred in holding that the letter from Wathen to Provident constituted a written contract which expressly dealt with and prohibited Wathen from paying dividends without first securing Provident's consent.

REASONS FOR GRANTING THE WRIT.

1. *The reversal by the Circuit Court of the decision of the Tax Court conflicts with the principles announced by this Court in Dobson v. Commissioner, 320 U. S. 489.*

The Tax Court found as a fact that the words "consulting you", as used in the Wathen-Provident agreement, had the meaning of "securing the consent of Provident." (R. 73)

The Tax Court held that it should consider the intent of the contracting parties and the circumstances surrounding the execution of the writing when deciding in which of its recognized senses the word "consulting" was used in the agreement. (R. 77)

And, as hereinbefore stated, the Tax Court found that:

> "Petitioner's letter to Provident, dated April 29, 1935, coupled with Provident's acceptance of its terms, followed by the making of loans to petitioner, constituted a written contract executed by petitioner prior to May 1, 1936, which expressly dealt with dividends and prohibited petitioner from the payment of any dividends in 1936 or 1937 without first securing the consent of Provident." (R. 73)

The essential facts were admittedly correctly found by the Tax Court (R. 95). The inferences from them were likewise correctly determined by the Tax Court.

Certainly, the Circuit Court did not separate the elements of the decision so as to identify a clear-cut mistake of law. The Tax Court's decision had warrant in the record, a rational basis in the law, and the judicial function was exhausted. *Dobson* v. *Commissioner*, 320 U. S. 489, 501, 502.

The Tax Court has the primary function of finding the facts in tax disputes, weighing the evidence and choosing from among conflicting factual inferences and conclusions those which it considers most reasonable. The appellate courts have no power to change or add to those findings of fact or to reweigh the evidence. When the Tax Court's factual inferences and conclusions are determinative of compliance with statutory requirements, the appellate courts are limited to a determination of whether they have any substantial basis in the evidence. The skilled judgment of the Tax Court, which is the basic fact-finding and inference-making body, must thus be given wide range in such proceedings. *Commissioner* v. *Scottish American Investment Co., Ltd.*, 323 U. S. 119 (1944); see also *Commissioner* v. *Court Holding Co.*, 324 U. S. .... (1945).

To permit the Circuit Courts to reverse the Tax Court in cases like the instant one would require this Court to enter into a quagmire of particularities and to make detailed analyses of the special circumstances of all contracts of this sort, involved not only in § 27(c)(1) but in analo-

gous situations under the income taxing acts. *McDonald* v. *Commissioner*, 323 U. S. 57 (1944).

2. *The decision of the Circuit Court is in conflict with the decision of the Court of Claims in Rex-Hanover Mills Co. v. United States, 53 F. Supp. 235 (1944), with the decisions of the 8th Circuit in United States v. Dakota Tractor & Equipment Co., 125 F. (2d) 20 (1942) and Harding Glass Co. v. Commissioner, 142 F. (2d) 41 (1944), and with the decisions of the Sixth Circuit itself in Glenn v. Chess & Wymond, 132 F. (2d) 621 (1942) and Automotive Parts Co. v. Commissioner, 134 F. (2d) 420 (1943).*

In this Wathen case the Circuit Court held that, in determining the meaning the word "consulting" bore in the agreement, the Tax Court could not consider the circumstances surrounding the execution of the agreement or evidence of the intent of the contracting parties.

In the *Rex-Hanover Mills* case, *supra*, the allowance of the dividends paid credit turned on the question whether or not the words "surplus" and "net profits", used in the contract, were meant to include certain earnings of earlier years which had been capitalized by stock dividends. As between two possible meanings, the Court of Claims decided that the real meaning was to exclude such earnings. It based that finding on the conduct of the parties and on other circumstances extraneous to the wording of the contract. The Court allowed the credit notwithstanding the fact that the bare words needed explanation from surrounding circumstances.

In the *Dakota Tractor & Equipment Co.* case, *supra*, the Court resorted to extraneous circumstances in determining whether certain statements in the letter relied upon were intended to operate as a binding promise, satisfying § 26(c)(1), or were merely statements of business policy as was contended by the Government. The Court said (125 F. (2d), at p. 24):

> "Appellant contends the letter is not a statement of the terms of a unilateral contract but is merely a statement of 'business policy' which appellee intended to pursue. It seems clear that the letter is a statement of the terms of a proposed unilateral contract which became binding when the later contract* was executed. Both the testimony as to what brought about the letter and also the terms of the letter itself are convincing."

In the *Harding Glass* case, two writings were relied upon as constituting contracts prohibiting the payment of dividends. One of the writings required that all of Harding's surplus and earnings should be used for plant expansion or for the payment of specified obligations, but did not in terms refer to the non-payment of dividends. The other writing was a letter from Harding to its stockholder, Fourco Glass Co., which stated:

> "We agree to the conditions stated in a loan agreement made of even date * * * between you and the Diamond Alkali Co."

The loan agreement referred to provided that Fourco would not permit Harding to pay dividends while Fourco was indebted to Diamond; it was not executed by Harding.

The Eighth Circuit held that each of the instruments executed by Harding constituted a written contract expressly dealing with and prohibiting the payment of dividends, although neither of them contained any reference to dividends and one of them merely agreed to the unspecified terms of a wholly separate instrument.

In the *Chess & Wymond* case, a bank wrote Chess & Wymond, which was seeking a line of credit (40 F. Supp., at p. 668):

> "We understand that you feel obligated to declare and pay preferred dividends on your new issue, requiring $28,000 per year. While we feel that it is wrong in principle for stockholders to withdraw money from this

* Agency contract containing no reference to dividends.

company in view of its present need, the amount is relatively small in relation to the contemplated earnings. We would definitely oppose the payment of such dividends, however, should the earnings fall under $30,000 per quarter."

Chess & Wymond replied (40 F. Supp., at p. 668):

"Thanks very much for your letter of December 18 which will be very helpful and is greatly appreciated."

A loan was made by the bank.

The Sixth Circuit affirmed (132 F. (2d) 621) the decision of the District Court which had held that these letters, indefinite as they were, should be construed in view of the "intention of the contracting parties" (40 F. Supp., at p. 670) and the "subsequent conduct of the parties" (40 F. Supp., at p. 671), that such intention was "controlling in the decision of this case" (40 F. Supp., at p. 670), and that, therefore, Chess & Wymond was entitled to a credit under § 26(c)(1).

In this Wathen case the Circuit Court sought to distinguish its decision in the *Chess & Wymond* case by merely saying:

"The Tax Court relied on *Glenn, Collector, v. Chess & Wymond*, 132 F. (2d) 621 (C. C. A. 6). From our viewpoint that case does not sustain respondent's contention. The facts in that case show that there was an exchange of letters* (40 F. Supp. 666); and this court held that the letters resulted in a written contract expressly dealing with the payment of dividends. Our decision therein was based upon the contract and not upon extraneous considerations." (R. 100)

In the *Automotive Parts Co.* case, *supra*, the creditor telegraphed Automotive that it felt Automotive's creditors

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* If by emphasizing "exchange of letters" the Court meant to hold that a unilateral contract—a written promise signed by the taxpayer and acted upon by the making of a loan—is not sufficient under § 26(c)(1), the decision conflicts with *United States* v. *Hillcrest Investment Co.*, 147 F. (2d) 194 (C. C. A. 8th, 1945).

should have the protection of a provision regarding dividends. Automotive's President replied that he would be willing to enter into any reasonable agreement concerning dividends, but looked to dividends in the sum of $6,000 a year to liquidate an existing personal obligation of his. The creditor then wrote back:

> "We understand the situation regarding dividends and are entirely satisfied." (134 F. (2d), at p. 421)

A loan was made.

The Sixth Circuit held that this exchange of letters and telegrams constituted a contract expressly dealing with and operating as a restriction on the payment of dividends and that Automotive was therefore entitled to a dividends paid credit.

3. *The decision of the Circuit Court in the instant case is so patently erroneous as to call for an exercise of this Court's power of supervision.*

The Circuit Court said:

> "There is no suggestion that consulting implies obtaining consent." (R. 99)

The Court apparently overlooked the fact that all standard dictionaries establish that the word "consult" means "to apply for instruction", i.e., "to apply for an authoritative command * * * or order intended as a rule of action or conduct."

Webster's New International Dictionary, 2d Edition, defines "consult" as meaning "to apply for * * * instruction * * *". That dictionary defines "instruction" as "that which is given by way of direction or command, orders, esp. as to duty or procedure; as, instructions to a jury; instructions to a servant". That dictionary also defines "instruction" as "a precept", and defines "precept" as "an authoritative command; order; mandate * * * any commandment, instruction or order intended as a rule of action or conduct * * *".

Funk & Wagnalls New Standard Dictionary of the English Language defines "consult" as "to apply to for direction * * * to ask advice or direction from another". It then defines "direction" as "instruction how to proceed; command; order".

The *Century Dictionary and Cyclopedia* defines "consult" as "have recourse to for information or instruction". It defines "instruction" as "direction given; order; command; mandate."

It is thus seen that the bare words of the Wathen letter, without recourse to any outside circumstances or evidence of the intent of the contracting parties, in terms require Provident's consent to any payment of dividends.*

The Circuit Court apparently did not realize this and felt that the word "consult" standing alone could not mean "obtain consent".

The Circuit Court then held that in deciding whether a writing entitles a taxpayer to a credit under § 26(c)(1) it is not proper to construe the words of that writing in view of the circumstances surrounding its execution and the intent of the contracting parties, but that the court must look at the bare words standing alone as if in a vacuum. The Court gave no weight to the fact that the Wathen-Provident contract was drafted by businessmen in business surroundings before the enactment of the provision being construed. See *Rex-Hanover Mills Co.* v. *United States*, 53 F. Supp. 235, 246 (Ct. Cls., 1944).

In fact, the statute and the regulations do not require that a contract contain exact technical terms having only one meaning which, remote from human affairs, expressly prohibit the payment of dividends. They merely require that such a contract when construed according to ordinary rules of contract construction shall "operate as a legal restriction" upon the payment of dividends. Reg. 94, Art. 26-2(b).

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* In *Colyar* v. *Wheeler*, 110 Tenn. 58, 75 S. W. 1089, it was held that the words "upon consultation and getting advice from said trustee" meant "with the consent of the trustee."

The result arrived at by the Circuit Court is contrary to the intent of Congress. This high-rate surtax was enacted to combat a method of evading existing surtaxes by which stockholders with large incomes saw to it that corporations unreasonably accumulated profits so as to save the stockholders from having to pay income tax on dividends. Explaining why the provisions for credits were necessary, the Ways and Means Committee said, "It has been recognized that in certain cases corporations cannot pay out dividends or that sound policy demands the non-payment of dividends." 74th Cong., 2d Sess., Rep. No. 2475, p. 8. See also Senate Finance Committee, Rep. No. 2156, 74th Cong., 2d Sess., p. 12. The present case is one, as the Circuit Court admits, where the corporation was bound not to declare a dividend. It is one of the cases Congress intended to relieve.

CONCLUSION.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Sixth Circuit should be granted.

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May, 1945.